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August 28, 2003

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station
Boston, MA 02 110

Re: D.T.E. 03-47, Boston Edison Company, Cambridge Electric Light Company, Commonwealth Electric Company, NSTAR Gas Company, Pension/PBOP Adjustment Mechanism Tariff Filing

Dear Secretary Cottrell:

Enclosed for filing is the Reply Brief of Boston Edison Company, Cambridge Electric Light Company, Commonwealth Electric Company and NSTAR Gas Company in the above-referenced proceeding.

Thank you for your attention to this matter.

Sincerely,

Robert J. Keegan (ANW)

Robert J. Keegan

Enclosures

cc: Service List

COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Boston Edison Company Cambridge Electric Light Company Commonwealth Electric Company NSTAR Gas Company	)	D.T.E. 03-47

CERTIFICATE OF SERVICE

I certify that I have this day served the foregoing document upon the Department of Telecommunications and parties of record in accordance with the requirements of 220 C.M.R. 1.05 (Department's Rules of Practice and Procedures).

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Dated: August 28, 2003

COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Boston Edison Company	)	
Cambridge Electric Light Company	)	D.T.E. 03-47
Commonwealth Electric Company	)	
NSTAR Gas Company	)	

REPLY BRIEF OF BOSTON EDISON COMPANY, CAMBRIDGE ELECTRIC LIGHT COMPANY, COMMONWEALTH ELECTRIC COMPANY AND NSTAR GAS COMPANY

Submitted by:

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Dated: August 28, 2003

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REPLY BRIEF OF BOSTON EDISON COMPANY, CAMBRIDGE ELECTRIC LIGHT COMPANY, COMMONWEALTH ELECTRIC COMPANY AND NSTAR GAS COMPANY

Boston Edison Company ("Boston Edison"), Cambridge Electric Light Company ("Cambridge"), Commonwealth Electric Company ("Commonwealth") and NSTAR Gas Company ("NSTAR Gas") (together, "NSTAR" or the "Company") submit this Reply Brief to the Department of Telecommunications and Energy (the "Department") concerning the Company's proposed pension/PBOP reconciliation-adjustment mechanism (the "PAM"). The PAM is designed to address the existing conflict between ratemaking, accounting and tax requirements for the funding of pension and PBOP benefits. The Company's proposed tariffs in this case implement a reconciling ratemaking mechanism for the recovery of pension and PBOP expenses that would accomplish two primary objectives: (1) to ensure that customers pay no more and no less than the amounts actually needed to provide pension and PBOP benefits to retired employees; and (2) to avoid unnecessary harm to the Company and its customers as a result of the financial-reporting issues that arise from the extreme volatility of pension and PBOP obligations. The Company's Reply Brief addresses the arguments raised by the Attorney General in his Initial Brief.[1] For the reasons described in the Company's Initial Brief, as well as those described herein, the proposed PAM tariffs should be approved by the Department.

I. INTRODUCTION

In this proceeding, the Company is proposing to establish a reconciling ratemaking mechanism to deal with the existing conflict between traditional cost-of-service ratemaking, accounting and tax requirements for the funding of pension and PBOP benefits. In that regard, there is no dispute in this proceeding that, since the commencement of accounting requirements under FAS 87 and FAS 106, it has been exceedingly difficult for the Department to devise and to apply a consistent standard for the recovery of pension and PBOP costs by utilities subject to its jurisdiction. Nor is it disputed that the circumstances experienced in the financial markets over the past few years represent a significant test of the interaction between the Department's ratemaking treatment of pension/PBOP expense, accounting requirements and tax policy. Lastly, nothing in the record suggests that the circumstances that the Company faces today are not bound to be repeated with equally detrimental results in the future. Therefore, the Company's proposal is focused on the development of a ratemaking mechanism that will allow for the recovery of pension and PBOP expenses in an objective, standardized, fair and workable manner that will withstand the test of time. Moreover, the Company's

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[1] Many of the issues raised by the Attorney General in his initial brief were addressed by the Company in its Initial Brief, and will not be repeated at length in this Reply Brief. NSTAR does not intend that its silence concerning any matter reflects agreement with positions taken by the Attorney General in this proceeding. To the contrary, the Company reasserts the positions and arguments made in its Initial Brief.

proposal is consistent with similar ratemaking mechanisms adopted by the Department for other cost categories (e.g., variable fuel costs and environmental remediation costs) that are: (1) beyond the control of the Company and reasonably predicted to recur; (2) variable in terms of the amount of the expense and its periodicity; and (3) large enough in nature and amount to trigger otherwise unnecessary general rate proceedings (see cases cited in Company Initial Brief at 22-24).

The Attorney General's Initial Brief is notable in that his arguments are not focused on the merits of the Company's proposal to establish a ratemaking mechanism outside of base rates, or on whether pension and PBOP expenses exhibit the characteristics of other cost items currently collected through reconciling mechanisms, such as fuel charges and environmental cleanup costs. The Attorney General has not argued that reconciliation adjustment mechanisms are improper as a ratemaking methodology.[2] Nor has the Attorney General challenged the standard of review against which the Company's proposed reconciliation mechanism should be judged by the Department.

Rather, the Attorney General focuses his claims on whether certain pension and PBOP costs, at this particular point in time, should be recoverable from customers. Because the Attorney General views the issue as a temporary and one-time request for cost recovery, the Attorney General's claims are that the Department must conduct a full-blown, revenue-requirements rate case "...either in this case or in future PAM reviews"

[2] In Boston Edison's Restructuring Settlement Agreement, the Attorney General endorsed the concept of the reconciliation of pension and PBOP expenses (Company Initial Brief, at 11, citing Boston Edison Company Restructuring Settlement Agreement, at 8 ftnt.5, as approved by the Department in Boston Edison Company, D.P.U. 96-23 (1998)).

and that no adjustment of increased pension/PBOP expenses is warranted because the Company may be earning more than its allowed rate of return (Attorney General Initial Brief at 9). However, these arguments go not to the fundamental policy decision before the Department, nor to merits of the Company's proposal to establish a long-term ratemaking solution to the treatment of pension and PBOP costs. Instead, the Attorney General's comments are designed only to present road blocks to the Department's determination of the issues in this case. Accordingly, for the reasons discussed below, the Department should reject the Attorney General's claims and approve the Company's proposed reconciliation mechanism for pension and PBOP costs.

II. ARGUMENT

A. The Company's Proposed Reconciliation Mechanism Is Reasonable and Does Not Constitute a Single-Issue Rate Case.

The Attorney General argues that the Department should reject the Company's pension/PBOP adjustment mechanism because it is an example of the type of single-issue ratemaking disfavored by the Department (Attorney General Initial Brief at 5-7). However, the Attorney General has not argued that the Department is barred from undertaking an examination of the Company's proposed PAM because it constitutes a "single-issue rate case."[3] In fact, the Attorney General acknowledges that the Department has defined the term "single-issue" rate case to mean the investigation of a petition for *base rate relief* that concerns only one major issue (id. at 5). The Attorney General also acknowledges that the Department may make an exception and allow single-

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[3] In this case, the Department has already ruled that, even if it were a single-issue rate case (which the Company asserts it is not), there is no absolute bar to single-issue rate cases. Interlocutory Order on Motion to Dismiss, D.T.E. 03-47, at 8 (2003).

issue rate adjustments in limited and extraordinary circumstances. Therefore, the Attorney General maintains that the Company "has not shown that a single-issue rate increase is justified in these circumstances" (id. at 7).

Notably, although the Attorney General confirms the Department's policy that single-issue rate cases are appropriate in certain circumstances, he fails to articulate any standard that defines the circumstances, which when present, would support a single-issue rate case. Without identifying any applicable measure or standard the Attorney General argues that the Company has not shown that a single-issue rate case is justified "in these circumstances" (id. at 5-6).[4] The Attorney General's argument is without foundation or merit because the Company's proposal does not constitute a single-issue rate case, and even if it did, there is no legal bar attributable to single-issue rate cases.

NSTAR is not seeking to increase base rates, but rather is requesting approval of a fully reconciling adjustment mechanism that functions *outside* of base rates. The harm sought to be avoided by the Department by "disfavoring" single-issue rate cases arises when a utility seeks to increase its base rates (on a "permanent" basis) because of a single cost element that has increased, without examining potential other offsetting reductions in its costs that would eliminate or reduce the need for the requested base rate increase. The

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[4] The Attorney General admits that the Department single-issue rate case policy is a prudential rule rather than an absolute bar, and that the judgment on such petitions is necessarily circumstantial, concerning, as it must, the exigency of the problem and the importance of potential relief (Attorney General Initial Brief at 7, *citing* Default Service Order, D.T.E. 02-40-B, at 20 (2003)). Indeed, according to the Attorney General, the Department has allowed single-issue rate adjustments in several circumstances, citing Cambridge Electric Light Company, D.P.U. 490, at 2 (1982) (single-issue adjustment allowed for large property tax increases); Capital Recovery, D.P.U. 859, at 6 (1982) (single-issue depreciation increase allowed after federal represcription); Tax Reform Act, D.P.U. 87-21-A at 11 (single-issue "generic" and "uniform" income tax reductions ordered after federal Tax Reform Act); Berkshire Gas Company, D.T.E. 98-65 (1998) (single-issue gas unbundling allowed); Default Service, D.T.E. 02-40-B at 18-20 (2003) (Attorney General Initial Brief at 6).

proposal in this case will not increase base rates, but is designed to establish a fully reconciling adjustment mechanism (i.e., a reconciliation to actual dollars booked by the Company) *outside* of base rates.[5]

In addition, it is an uncontested matter of law in this case that, even if the Company had made a proposal that was construed as a single-issue rate case (which it has not), there is no Department prohibition against single-issue rate cases.

> In discharging its ratemaking functions, the Department maintains a general, but hardly inflexible policy against so-called single issue rate cases....[T]here is no absolute bar to single-issue rate cases.

Interlocutory Order on Motion to Dismiss, D.T.E. 03-47, at 7-8 (August 7, 2003), citing, Tax Reform Act, D.P.U. 87-21-A at 6, 7 (1987) and Default Service, D.T.E. 02-40-B at 18 (2003) (first citation) and (id. at 8, citing Default Service, D.T.E. 02-40-B at 20; Cambridge Electric Light Company, D.P.U. 490, at 2 (1982); Capital Recovery, D.P.U. 859, at 6 (1982); and New England Telephone and Telegraph Company, D.P.U. 84-267, at 13 (1985).

> In short, while the issue of whether the proposed reconciliation mechanism for pension costs is a single-issue rate case is in dispute, even were the proposal to be categorized as a single-issue rate case, there is no absolute bar to taking up or considering such matters, only a policy disposition against such consideration, which can be overcome if circumstances warrant.

Interlocutory Order on Motion to Dismiss, D.T.E. 03-47, at 9 (August 7, 2003).

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[5] The Attorney General argues that a single-issue rate case also may occur where a company seeks an increase to revenues related to a base rate item, even though the company does not petition for a change to base rates (Attorney General Initial Brief at 5). The Attorney General provides no citation to support this expansion of the Department's traditional use of the term "single-issue" rate case (which includes base rate relief only). Moreover, the Company's proposal is fully reconciling, which means that the Company's revenues will be reduced, rather than increased, in the future. Accordingly, the Attorney General has improperly cast the Company's proposal as a single-issue rate case.

The Company's Initial Brief included an extensive discussion of the factors considered by the Department in determining whether an expense category should be recovered as part of a reconciliation mechanism include the following: (1) the financial impact of the expense on the Company (including the nature, size and periodicity of the cost); (2) the degree to which the Company has the opportunity to control the cost category (and the recurrence of the cost); and (3) whether approval of a separate adjustment clause will avoid otherwise unnecessary general rate proceedings (Company Initial Brief at 22-24). As described more fully in the Company's Initial Brief, the record in this case justifies the Department's approval of the Company's proposed Pension/PBOP Adjustment Mechanism because without it, the Company and its customers will face detrimental (and unnecessary) financial consequences relating to an extraordinary charge against common equity and the write-off of regulatory assets (id. at 24-27).

Moreover, the level of pension and PBOP expense that the Company is required to recognize in any given year is a function of accounting requirements, and not of the Company's own actions. The application of these mandated accounting standards, when coupled with financial and market changes, creates large swings in what must be booked for accounting purposes. As a result of the Company's proposal, rates in the future will rise and fall more gradually and with certainty, thereby reducing rate volatility and protecting customers from overpaying for the Company's pension and PBOP expenses (id. at 27-29).

Without a separate mechanism to adjust rates to provide for the timely recovery of expenses relating to the Company's pension and PBOP obligations, changes in volatile financial markets will force a series of unnecessary general rate cases. Absent the approval of the PAM tariffs, the immediate filing of four rate cases is the only option available to the Company over the short term (id. at 29). In addition, there is nothing in the record to suggest that the circumstances present today will not be repeated in the future, requiring further intervention by the Department. The record in this proceeding demonstrates the need for the Department's approval of the Company's proposed ratemaking mechanism to provide rates and earnings stability, to ensure that customers pay no more or no less than the amounts needed to provide pension and PBOP benefits to employees and retirees, and to avoid the financial impairment of the Company that arises from accounting requirements associated with the volatility of pension and PBOP funding obligations.

B. The Company's Proposal Does Not Constitute a General Increase in Rates Under G.L. c. 164, § 94.

Having failed to establish that the Company's proposal is barred as a "single-issue" rate case, the Attorney General maintains that the Company's proposed PAM must be construed as a "general increase in rates" pursuant to G.L. c. 164, § 94. As a general increase in rates, the Attorney General maintains that the Department must conduct an investigation that includes a test-year cost-of-service study with *pro forma* adjustments, and a review of the Company's earnings to determine whether the increase is needed to ensure reasonable compensation (i.e., whether the rates are confiscatory or "exorbitant") (Attorney General Initial Brief at 7-9). The Attorney General also asserts that NSTAR has continuously earned above its allowed return on equity for each of the last three years, and 350 basis points above the return on common equity that the Department would authorize in a rate case based on current market conditions (id. at 10-11).[6] The Attorney General's arguments are without merit.

Even if the Company's tariff filing in this case were properly construed as a general increase in rates (which it is not), the Attorney General's argument is off the mark because he assumes wrongly that section 94 requires, as a matter of law, the production of specific filing data and studies (e.g., a test-year cost-of-service study and cost-of-equity study) for review by the Department as part of a general increase in rates. General Laws c. 164, § 94 does not include any such requirement, even where a filing constitutes a "general increase in rates." Verizon Massachusetts, D.T.E. 01-31 (Phase II), at 71 (2003) ("we determine that our statutory mandate does not require us to conduct a cost-of-service study . . ."); see also 220 C.M.R. 5.06: Notice of General Rate Increases to Customers of Gas, Electric, Water and Telephone Companies.

> [W]here we do decide to use a cost standard for judging whether rates are just and reasonable, we [the Department] are free to choose the appropriate cost standard, whether it be fully-allocated, historic cost, marginal cost, TELRIC, or TSLRIC. See American Hoechest Corp. v. Department of Pub. Utils., 379 Mass. 408, 413 (1980) ("[W]hen alternative methods are available, the [D]epartment is free to select or reject a particular method as long as its choice does not have a confiscatory effect or is not otherwise illegal"); New England Tel. & Tel. Co. v. Department of Pub. Utils., 371 Mass. 67, 71 (1976) (holding that although the Department is not required to use a method based on an adjusted historic test year in rate proceeding, it is permitted to do so.

Verizon Massachusetts, D.T.E. 01-31 (Phase II) at 72.

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6 According to the Attorney General, the Department has found in its most recent decisions that the cost of common equity for both electric and gas companies is approximately 10.5 percent (Attorney General Initial Brief at 11). The Attorney General maintains that NSTAR earned a return on average common equity in 2002 of 14.0 percent, after eliminating the effect of a write-down of the Company's investment in RCN (id. at 10). However, as explained below, this is an apples-to-oranges comparison because the Department establishes a return on rate base, and not a composite corporate return made up of regulated and non-regulated businesses.

The Attorney General's citation to NYNEX, D.P.U. 94-50 (1995) supports the Company's position in this case. Although the Department there found that annual price-cap filings "would most likely constitute a general increase in rates" under G.L. c. 159, § 20, the Department stated that its investigation would be "routine" and that the new tariffs need not even be suspended in order to conduct its investigation. D.P.U. 94-50, at 219, ftnt. 129.

> Even for a general increase in rates, the statute permits, but does not compel, a tariff suspension for purposes of a Department investigation. See G.L. c. 159, §§ 19, 20.

Id.[7] Indeed, in Bell Atlantic's fifth annual price-cap compliance filing, the Attorney General requested that the Department require Bell Atlantic to put into effect, *without any suspension*, a $48 million reduction in rates. Interlocutory Order on Suspension of Bell Atlantic-Massachusetts' Fifth Annual Price Cap Compliance Filing, D.T.E. 99-102, at 2 (2000) (emphasis added).

> Pursuant to G.L. c. 159, §§ 19 and 20, the Department "is accorded broad discretion in allowing, suspending and investigating proposed changes to tariffs." NYNEX, D.P.U. 95-83, at 13-14 (1995) (citations omitted).

New England Telephone and Telegraph Company, D.P.U. 96-68, at 12 (1996).

The fact of the matter is that reconciliation adjustment mechanisms, such as the fuel charge and the cost-of-gas-adjustment clause, historically have been adopted by the Department to eliminate the need for what would otherwise be a long and resource-intensive Department base rate proceeding. Fully reconciling cost recovery mechanisms

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[7] In NYNEX, D.P.U. 84-267 (1985), the Department required NYNEX to participate in a general rate proceeding because the company sought "across-the-board" tariff changes for "almost all of the Company's services." D.P.U. 84-267, at 5, 7. NYNEX did not submit a fully reconciling adjustment clause.

are reasonable and appropriate where legitimate costs are relatively volatile, outside of the control of the Company, and represent a substantial cost to the Company. Worcester Gas Light Company, 9 P.U.R. 3d 152 (1955) ("Worcester"). In Worcester, the Department's consideration in favor of approving a natural gas reconciliation clause outside of a full base rate case review was made, in part, to avoid the burdensome nature of such proceedings where other controlling factors (i.e., the marketplace for natural gas) were present. According to the Department, without the use of such reconciliation mechanisms the Department would have otherwise had to engage itself in:

> a very long and protracted series of rate hearings occupying a substantial length of time, involving substantial expense to both the companies and to the [C]ommonwealth and orders in which would necessarily, unless they were all issued at one time, prejudice one company as against another. It does not seem to us that either good regulation or common sense requires this result...

Id. at 156. Accordingly, the Attorney General's suggestion that the Department consider the Company's proposal as a "general increase in rates" would vitiate the underlying public policy in favor of the Company's fully reconciling adjustment mechanism under the facts and circumstances presented by this case, and should be rejected by the Department.

After properly setting aside the Attorney General's claims for cost-of-service studies and other documentation, the Attorney General's "rate case" argument boils down to a charge that the Company is earning in excess of its allowed rate of return. As discussed in detail below, this charge is not supported by the facts. However, if the Attorney General believes seriously that the Company's earning are excessive, he can exercise his right, pursuant to G.L. c. 164, § 93, to require a Department hearing on the matter. It is well established that the Attorney General may exercise this statutory right at any time (including the day after receiving the Company's filing in this case).

> The Supreme Judicial Court has described § 93 as a procedure whereby petitioners can "compel official hearing of their grievances." Consumers Organization for Fair Energy Equality, Inc. v. Department of Public Utilities, 368 Mass 599, 609 (1975). Once a price-related issue is properly raised by a § 93 complaint, the Department is compelled by statute to give appropriate notice, hold a public hearing and order any suitable change in the price of gas or electricity.

Interlocutory Order Regarding Scope of Proceeding and Motion to Compel Discovery, Fitchburg Gas and Electric Light Company, D.T.E. 99-118, at 5 (2001). Yet, the Attorney General has not taken this available means to address his purported charge. Instead, the Attorney General seeks to use this case as an opportunity to make assertions that the Company is earning in excess of its allowed rate of return. These assertions are incorrect and unsupported by the record.

The Department has set the cost of equity for each NSTAR distribution company in several different rate proceedings, and the current cost of equity capital for each distribution company is the cost of equity most recently approved by the Department (Exh. AG-1-49). Notably, the Attorney General cites the Department's recent decision in Berkshire Gas Company, D.T.E. 01-56, at 118-119, which establishes a cost of common equity for both electric and gas distribution companies at 10.5 percent (Attorney General Initial Brief at 11).

The Attorney General's assessment of the Company's earnings is based on a misplaced reliance on the return on common equity over the last three years, an inappropriate focus on combined regulatory and non-regulatory returns and the absence of appropriate gas revenue adjustments for weather normalization. The equity return on distribution rate base is a far-better indicator of a company's "regulatory" earnings for ratemaking purposes than the overall Company return on common equity in terms of assessing the Company's return (Exh. AG-1-10). The following table summarizes the percentage return on rate base for the three-year period 2000 through 2002:

Percentage Equity Return on Rate Base

Distribution Company	2000	2001	2002
Boston Edison Company	9.4%	9.1%	8.0%
Commonwealth Electric Company	8.5%	7.9%	6.0%
Cambridge Electric Light Company	6.3%	8.3%	10.1%
NSTAR Gas Company	12.5%	10.6%	6.6%

(Exh. AG-1-10). As shown, in 2002, each NSTAR distribution company actually earned less than 10.5 percent rate of return cited by the Attorney General. Moreover, the record establishes that the Company would seek base rate increases of approximately $75 million *in addition* to those relating to the pension and PBOP expense, if it were required to file cost-of-service rate cases at this time (Tr. 1, at 45-46 [Judge]). Accordingly, the Attorney General's assessment that the Company has consistently earned in excess of the current cost of equity is contrary to the record evidence and should be rejected by the Department.

C. The Department's Approval of the Proposed PAM Will Not Alter the Company's Cost of Common Equity.

The Attorney General argues that the Company's proposed PAM would decrease the Company's cost of capital, including its cost of equity, because it would shift the risks of the changes in pension and PBOP costs from the shareholders to the customers (Attorney General Initial Brief at 10). The Attorney General's assertions are based on faulty analyses, leading him to an erroneous conclusion.

The Company is already earning well below the last allowed returns authorized by the Department in each distribution company's last rate case, and even below the returns allowed by the Department in recent rate orders, as cited by the Attorney General. Thus, there would be no need to make any further adjustment to account for the approval of the proposed rate mechanism. Moreover, even in the context of establishing a revenue requirement for the Company, there would be no need to make a specific adjustment to the cost of equity to reflect the approval of the mechanism.

Historically, the Department has allowed recovery of prudently incurred pension and PBOP costs based on some test year measure of representative expense levels (Tr. 1, at 40 [Judge]). Therefore, until recently, shareholders have not anticipated any particular increased risk associated with the recovery of these costs into their required return on equity (id.). However, greater volatility associated with pension and PBOP expense has been experienced in the last few years, as caused by stock market declines and other market forces. These events culminated, at the end of 2002, with the prospect of a large write-down of equity for NSTAR (Exh. PwC-RJS, at 3-4). This *additional* risk, if not addressed by the proposed reconciliation mechanism, will translate into higher required returns on equity relating to the Company's ability to recover the full amounts expensed on its books for pension and PBOP expense (Tr. 1, at 40 [Judge]):

> So I don't believe that shareholders, until very recently, have become concerned about this. The level of volatility is really a new phenomenon, and I don't think our cost of capital would necessarily decrease as a result of this pension mechanism for those reasons.

Id. Indeed, if the Department does not approve the PAM, the Company's cost of common equity will *increase* because the Company will be forced to take a large charge to common equity, which will have negative effects on the Company's bond ratings, credit ratings and stock prices (Exh. DTE-3-2; Exh. DTE-3-3). Reductions in stock prices would *increase* the cost of equity (Exh. DTE-3-2; Exh. AG-1-58). Accordingly, the Attorney General's argument that Department approval of the Company's PAM should result in a reduction in the cost of equity is without merit.

D. The Approval of the Proposed PAM Avoids Significant and Adverse Financial Effects on the Company and Its Customers.

The Attorney General contends that the Company has not shown that its proposal is needed to avoid financial impairment (Attorney General Initial Brief at 13). According to the Attorney General, the Company has not demonstrated the volatility of pension and PBOP expense, nor why pension costs should be treated any differently than other expenses that are included in the Company's base rate revenue requirement (id. at 12). Nor "is it clear" to the Attorney General that the Company would actually write-off equity absent Department approval of its proposal, and even if such a write-off would occur, whether it would necessarily lead to financial impairment (id. at 13).[8] The Attorney General's contentions are contradicted by a large body of record evidence establishing that, in the absence of the proposed PAM, the Company and its customers will face detrimental (and unnecessary) financial consequences relating to an extraordinary charge against common equity and the write-off of regulatory assets (Tr. 1, at 83-84 [Judge]).

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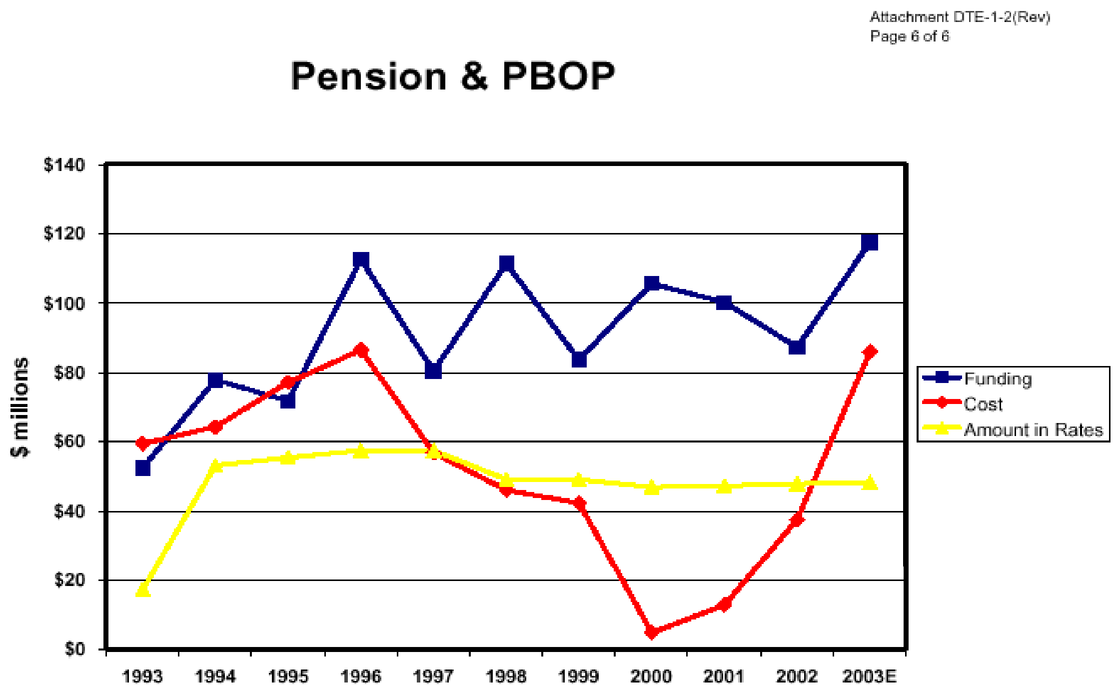
[8] The Attorney General also implies that "theoretically" the Department's accounting ruling could have waited until March 2003, without requiring a write-down of common equity. However, as Mr. Judge testified, "delayed and restated earnings...creates uncertainty in the financial markets" (Tr. 1, at 24 [Judge]). Thus, any delay would have, itself, created the type of negative financial impacts that the Company sought to avoid through the accounting ruling.

The volatility of pension and PBOP expense from year to year is dramatic, as represented in the graph below (Exh. DTE-1-2 (Rev), Attachment DTE-1-2 (Rev), at 6). As shown, the 1996 pension and PBOP cost is approximately $90 million, dropping to nearly $0 in 2000 and then increasing to approximately $90 million again in 2003.



The Company addressed the issue of the necessity of a write-off in its Initial Brief and will not repeat its position in it entirety here (Company Initial Brief at 24-27). Suffice it to state that the Attorney General's witness, Mr. Effron, stubbornly refused to acknowledge that the Company would have been required to take the charge to equity if the Department had not approved the accounting ruling in D.T.E. 02-78 (Exh. AG-2, at 9; Tr. 2, at 233 [Effron]). Mr. Spear, the engagement partner for the Company's independent auditors, presented unambiguous testimony about the consequences if the Department had not approved the accounting ruling (Exh. PwC-RJS, at 3-4; Tr. 1, at 147

[Spear]; see also Exh. AG-2-6, Attachment AG-2-6 (contemporaneous internal memoranda of PwC)).

Notwithstanding the Attorney General's uncertainty concerning the financial impairment associated with the failure to approve the PAM, the record evidence demonstrates that such impairment would result and be substantial. A charge to the Company's common equity account would have a detrimental effect on NSTAR's financial health in at least three ways:

1. Bond Ratings

   The Company's bond ratings are likely to be downgraded, which will increase costs that the Company will incur to raise capital and finance utility operation;

2. Access to Capital

   The Company's credit agreements may be negatively affected by a downgrading, which could further impair the Company's access to capital to continue financing system improvements and fund utility operations;

3. Reductions in Stock Price

   The Company's stock price would likely suffer, which would increase future costs of equity.

Exhibit AG-1-58. Each of these negative effects would flow through to customers, largely in the form of higher costs for the Company to attract capital and more volatility in distribution rates (Exh. AG-1-60).

The risk to customers is great in the event the Department were to find "shelter" in the purported uncertainty of financial consequences expressed by the Attorney General. As demonstrated above, each of the Attorney General's challenges to the significant impairment faced by the Company in the absence of the PAM is without merit.

E. The Company's Proposed Pension Adjustment Mechanism Is Properly Calculated and Will Result in Actual Contributions to Employee Pension and PBOP Trust Funds.

The Attorney General makes several charges concerning the Company's calculation of the PAM (Attorney General Initial Brief at 14-16). According to the Attorney General, the Department should not allow the recovery of carrying charges on the net prepaid pension and PBOP balance because it would be inconsistent with Department precedent (id. at 14).[9] The Attorney General also maintains that the Companies have understated the pension and PBOP expenses currently being recovered through rates because of system growth since the early 1990s (id. at 15). Finally, the Attorney General alleges that the Company's proposal does not require it to make any contributions to its pension or PBOP trust funds (id. at 15-16). The Attorney General's critique of the calculation of the PAM is mistaken, as is his assessment of the Company's funding obligations.

The prepaid pension amount carried on the Company's books is created as a result of the Company making cash contributions to its pension trust that are in excess of the accounting expense that is recorded on the Company's books (i.e., the Company cannot expense amounts on its books greater than the amount calculated pursuant to SFAS 87 and SFAS 106) (Tr. 1, at 145 [Spear]). The reason such contributions are made in excess

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[9] The Attorney General mistakenly attacks the carrying-charge calculation based on the argument that "NSTAR was not measuring correctly the cash required by investors to cover the difference between the actual recovery of pension expense in rates and cash disbursements to the pension plan" (Attorney General Initial Brief at 14). As described in the Company's Initial Brief, this is precisely what the formula does (Company Initial Brief at 19-20, citing Exh. AG-1-30). The Attorney General also erroneously compares NSTAR Gas' pre-tax carrying cost rate with the post-tax return on equity allowed by the Department in a recent rate case (Attorney General Initial Brief at 15). These rates are not directly comparable since the pre-tax rate is intended to provide for the recovery of income taxes associated with the return on equity.

(i.e., prepaid) of the booked amount for SFAS 87 or SFAS 106 is because ERISA/IRS rules permit different amounts to be contributed to the trusts on a tax-deductible basis than amounts booked according to SFAS 87 and 106. Thus, the Company has traditionally contributed up to the maximum tax-deductible amount to the trusts, recognizing the benefit that such a contribution will accrue for tax purposes.[10]

In many orders over the years, the Department indicated that it is appropriate for companies to make cash contributions to its pension and PBOP funds equal to the maximum allowable tax deductible amount (i.e., regardless of whether such an amount exceeded SFAS 87 "booked" amounts).

> The Department encourages companies to take optimum advantage of the benefits attendant to the funding of PBOPs. Tax-free accumulation of assets in a trust with appropriate safeguards should ultimately result in lower over PBOP costs for ratepayers.

Cambridge Electric Light Company, D.P.U. 92-250, at 54 (1993). See also Bay State Gas Company, D.P.U. 92-111, at 226 (1992) and Massachusetts Electric Company, D.P.U. 92-78, at 83 (1992) (the Department finds that funding at levels equal to the maximum allowable tax deductible amount strikes the best balance between the interests of ratepayers and shareholders).

In fact, the Department previously has allowed companies to defer with carrying charges at the allowed rate of return the difference between the amount of PBOP expense

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10 FERC precedent has also permitted carrying charges on prepaid pension expenses. Cities of Greenwood and Seneca, South Carolina v. Duke Power Company, 77 FERC ¶ 63,017 at Item 14 (Initial Decision) (1996). Even though such prepayments were not required by law, the decision allows carrying charges because the prepayments were made for the purpose of maximizing the tax benefits and minimizing current pension expenses. "As a result of these prepayments, Duke has lowered its current and ongoing O&M expenses in a manner similar to a utility making capital investments" (id.).

recovered in rates and amounts actually funded. Cambridge Electric Light Company, D.T.E. 92-250, at 54 (1993) ("The Company may defer the difference between the amount recovered in rates and the tax-deductible amount it actually funds, plus carrying costs based on the allowed rate of return in this case, for consideration in the Company's next rate case"). The Department approved the same treatment for deferred pension costs in Boston Edison Company, D.P.U. 92-92 (1992) (Exh. NSTAR-JJJ at 19-20).

The Attorney General's assertion that the Company may be understating the pension and PBOP expenses currently being recovered through rates because of system growth since the early 1990s is a red herring. The Company's rates have been fixed by the Department based on the most recent base rate case for each operating company. Additional revenues attributable to incremental sales growth are used to cover incremental investment costs needed to serve new load and new customers. Had the Attorney General asked during the course of the proceedings,[11] he would have learned that the incremental cost of serving new customers and their associated load generally exceeds incremental revenue growth.[12] Thus, load growth does not provide the Company with additional revenues for pension and PBOP expenses.

The Attorney General's charge that that the Company's proposal does not require it to make any contributions to its pension or PBOP trust funds is without merit. Although the Attorney General is technically correct that the Company's PAM does not include a requirement to make actual contributions, ERISA law, regulations and IRS

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[11] The Attorney General should not be permitted to make such factual allegations on brief without developing the record by seeking information that would either prove or disprove his untested hypothesis.

[12] This is why, as described above, the Company faces revenue deficiencies despite growth in load.

rules impose such requirements. Moreover, there are real and practical incentives to make the contributions each year to the maximum extent allowed by law. ERISA and the IRS impose legal minimum contribution requirements based on section 412 of the IRS Code. Customers benefit through tax-free returns, thereby lowering future expenses and future costs to customers. As described above, the Company has a strong incentive to contribute up to the maximum allowable tax deductible contribution to its pension and PBOP trust each year to capture the maximum tax benefits associated with making such contributions.

The requirement that the Company use the funds obtained from customers through base rates or reconciliation mechanisms for the purpose they are designed for is no different from any other Company expense. Although it is conceivable that the Company could use this money for other purposes, the Company and its corporate officers ultimately must bear their legal and fiduciary obligation to the Company's shareholders, employees and customers. Customers will pay on a going-forward basis no more than the amounts required to fulfill the Company's current pension and PBOP obligations and the prepaid amounts not yet expensed (Exh. AG-1-30). Accordingly, the Attorney General's suggestion that the PAM may somehow be improperly diverted is without merit.

F. The Pension/PBOP Adjustment Mechanism Does Not Constitute Retroactive Ratemaking.

The Attorney General maintains that the Company's proposal represents the improper collection of costs after the expiration of the Company's rate freeze on September 30, 2003 that were incurred during the rate freeze (Attorney General Initial Brief at 17). According to the Attorney General, amounts sought to be recovered by the

Company that were incurred in 2002 (amortized over three years under the Reconciliation Adjustment), and expenses incurred in 2003 (under the Average Differential Amount) represent retroactive ratemaking, inconsistent with the rate freeze ordered in the NSTAR merger decision, D.T.E. 99-19 (id. at 16-18).[13]

The Department in its Interlocutory Order, already dismissed the argument that the proposal violates the merger rate freeze. Interlocutory Order on Motion to Dismiss, D.T.E. 03-47, at 10 (August 7, 2003). Similarly, the Attorney General misapplies the doctrine against retroactive ratemaking to the facts of this case.

The proposed recovery mechanism for pension/PBOP expenses does not violate the rate freeze or principles of retroactive ratemaking. As a result of FASB changes in accounting for pension and PBOP expenses, the Company's pension/PBOP expenses are no longer booked on a "pay as you go" basis, but are now based on projections of future financial obligations using a variety of actuarial and investment return assumptions (Exh. NSTAR-JJJ at 9-12). Therefore, the Company's "current" pension/PBOP costs are always a function, in part, of the Company's *actual* experience (as compared to forecasts using expectations of the future). Accruals in future years will need to account for actuarial and market investment results in previous years, once they occur. Thus, the accounting process under FASB rules requires an ongoing recalibration of expense amounts to reflect market and actuarial changes. Like other accrued expenses (e.g., depreciation), the prospective level of pension/PBOP costs is based, in part, on past

13 The Attorney General erroneously states that the four-year period ends on September 30, 2003 (Attorney General Initial Brief at 17). In fact, the "freeze" period ends four years after the merger was consummated, which occurred on August 25, 1999.

events without violating any reasonable precept of retroactive ratemaking. This is just as true under the existing base rate treatment for pension/PBOP as it would be under the Company's proposed pension/PBOP adjustment mechanism, and such prospective recovery does not violate the merger's four-year rate freeze.

III. CONCLUSION

For all of the reasons provided herein, the Company respectfully requests that its proposed Pension/PBOP Adjustment Mechanism tariffs, as set forth in Exhibits NSTAR-1, NSTAR-2, NSTAR-3 and NSTAR-4 be approved by the Department.

Respectfully submitted,

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COMMONWEALTH ELECTRIC COMPANY
NSTAR GAS COMPANY

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Dated: August 28, 2003